

**UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

**TECHNICAL CONFERENCE ON GENERATION MARKET POWER  
AND AFFILIATE ABUSE**

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**Introduction**

My name is David DeRamus, and I am a Partner with the economic consulting firm of Bates White, LLC. I would like to thank the Commission and the Commission Staff for the opportunity to present my views in this forum. While my comments in today's proceeding are not being sponsored by any market participant, I have recently submitted testimony on behalf of intervenors Calpine Corporation and Occidental Chemical Corporation in the market-based rate proceedings involving Entergy and AEP. Before I address the issue of buyer market power, which I consider to be one of the most significant manifestations of affiliate abuse in electric power markets today, I would also like to make a few comments about the overall importance of a thorough consideration of affiliate abuse issues, especially within the context of market based rate proceedings. Given the amount of attention focused on the generation market power screens, I am especially concerned that the other three prongs of the Commission's market power analysis – including not only affiliate abuse, but also transmission market power and barriers to entry – not become sidelined and ultimately neutered as substantive issues in market based rate applications.

**The Commission should perform a “searching inquiry” into affiliate abuse, particularly in market-based rate applications**

The issue of affiliate abuse arises in many different Commission proceedings, most obviously in Section 205 proceedings involving specific transactions between vertically integrated utilities and their wholesale generation and marketing affiliates. The issue of affiliate abuse may also arise within the context of acquisitions. As I noted in my comments in the Commission's June 2004 Technical Conference, acquisitions – and particularly distressed acquisitions – may be motivated by attempts to foreclose the wholesale market to competing generators, reflecting the incentives of some market participants to artificially

discriminate in favor of their own generating units. In fact, such acquisitions can provide good “natural experiments” to test the hypothesis of whether a market participant is engaging in affiliate abuse: if there is a change in dispatch or transmission access of the generating unit after the acquisition, and there is no other change in market fundamentals or infrastructure accompanying the acquisition, that can be a strong signal of affiliate abuse.

In market based rate applications, the Commission has both the opportunity and the obligation to assess whether, taken as a whole, an applicant is able to exercise market power through whatever means are at the applicant’s disposal, including affiliate abuse. In making this assessment, the Commission should conduct a “searching inquiry”<sup>1</sup> into the issue of affiliate abuse, as it would in reviewing a specific interaffiliate transaction that requires Commission approval. Just as the Commission would be ill-advised to apply a simple “check-the-box” approach in approving a specific interaffiliate transaction – e.g., by asking whether an applicant has on file an appropriate code of conduct – so, too, would the Commission be ill-advised to rely on such a “check-the-box” approach to affiliate abuse issues in market based rate applications.

In considering how high to set the “bar” for evaluating whether an applicant is able to exercise market power as a consequence of affiliate abuse, I would propose that the “bar” be set reasonably high, since affiliate abuse is one of the main underlying means by which market power can be exercised in wholesale markets, particularly in markets without a fully functioning RTO. Furthermore, even the *potential* for affiliate abuse results in self-reinforcing market power problems, since it perpetuates artificial advantages of an incumbent and establishes a barrier to entry for new competitors. Failing to identify the potential for affiliate abuse therefore has long-term negative consequences for competitive markets, and these are consequences that the Commission should not underestimate.

In thinking about the standard to be applied in assessing all of the other three prongs of the Commission’s market power test, I should also caution the Commission against focusing solely on the behavior of the applicant and ignoring the consequences of the structural features of the market at issue. For example, in a given market, there may simply be no *bona fide* competitive solicitation process or independent auction markets, and thus no mechanism through which competing generators can gain access to an adequate share of the wholesale market in order to discipline the pricing behavior of the applicant; that absence alone, independent of any explicit actions or intent by the applicant, may be sufficient to foreclose competition from certain markets. I have noticed a similar overemphasis on behavioral issues in the Commission’s inquiry into whether applicants have “erected” barriers to entry instead of inquiring simply *whether* such barriers to entry exist, regardless of the applicant’s role in erecting or perpetuating those barriers to entry. The mere existence of barriers to entry – such as a lack of adequate transmission capacity for new entrants – can be sufficient

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<sup>1</sup> See e.g. *Boston Edison Co. re Edgar Electric Energy Company*, Docket No. ER91-243-000, p. 20 (citing *Louisville Hydro-Electric Company*, 1 FPC 130, 133 (1933)).

to prevent a market from resulting in competitive prices and should be an important consideration before granting an applicant market based rate authority.

I should also note that the approach I am suggesting in evaluating the other three prongs of the Commission's market power test is no different than the Commission's approach to assessing generation market power. In the latter, the Commission makes its determination of the potential for the exercise of market power based on the structure of the market, i.e. the level of concentration in the market, rather than on the applicant's past pricing behavior.<sup>2</sup> I am simply suggesting that a lesser standard not be applied in evaluating the other three prongs of the Commission's market power test.

### **Applicants should not be allowed to define away the problem of affiliate abuse**

The issue of affiliate abuse is one area in which economists, attorneys, and regulators use the same terms but often with different assumptions about what those terms really mean. As an economist, I define affiliate transactions to encompass potentially any exchange of a good or service between related parties – i.e., any transaction for which the terms are dictated by administrative fiat and not by a *bona fide* market mechanism. Thus, when a load-serving entity uses its own generation facilities to deliver power to its native load customers, and when it transports that power over its own transmission lines, I consider that entity to have engaged in a series of affiliate transactions, regardless of whether or not there are observable accounting entries recorded for separate legal entities. I consider the potential for affiliate abuse to be largely independent of the legal structure of the applicant, since it is the substance and not the form of the transaction that matters for economic analysis.

This perspective is important to have in mind in assessing the efficacy of a code of conduct as a means of preventing affiliate abuse. If, for example, an applicant's code of conduct is inapplicable to certain important affiliate transactions – considered broadly – simply because of the legal structure of the firm or the particular nomenclature applied to the affiliate, then clearly such a code of conduct could not prevent affiliate abuse, even before considering the substance of the code of conduct itself. In other words, an applicant should not be able to “define away” the problem of affiliate abuse by implicitly or explicitly restricting its code of conduct from applying to important affiliated entities and transactions. Consistent with the need for a “searching inquiry,” the Commission must assess whether an applicant's specific code of conduct – within the context of the applicant's business structure and practices – will be effective in preventing affiliate abuse. Otherwise, relying on a code of conduct to prevent affiliate abuse without fully understanding how it will operate within the applicant's actual business could result in the Commission actually sanctioning preferential treatment of

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<sup>2</sup> I should note that I am strongly in favor of the Commission looking to actual historical data, and specifically the applicant's actual share of wholesale transactions in the market at issue, as a way of assessing the reliability of the results of generation market power tests that rely solely on capacity measures of market share.

affiliates. As a general matter, I should also emphasize that I have little faith in the efficacy of such behavioral remedies to affiliate abuse, but rather have a strong preference for structural remedies, as I will discuss further below.

### **Affiliate abuse includes the exercise of buyer market power**

Affiliate abuse constitutes any behavior through which a market participant is able to provide discriminatory advantages to its own competitive operations as a consequence of its regulated monopoly operations. The most obvious form of affiliate abuse occurs when a utility is able to cross-subsidize its unregulated marketing operations with its regulated operations, i.e. offering wholesale customers with lower cost power by inappropriately shifting costs onto its captive retail customers. Affiliate abuse similarly includes a utility using its preferential access to financial markets in order to subsidize the otherwise more costly financing of its merchant activities, or a utility re-acquiring its previously independent merchant operations. “Transmission market power” is also effectively a form of affiliate abuse, since when it occurs, a vertically integrated utility typically uses its monopoly over transmission service in order to provide its own generation affiliates with advantages that are not afforded to competing generators.

Yet another form of affiliate abuse is the exercise of buyer market power, in which a vertically integrated utility uses its regulated monopoly native load franchise – and its resulting position as the dominant actual or potential buyer of wholesale power in a given market – in order to foreclose access by competing generators to the wholesale market. Buyer market power is, of course, simply the flip-side of seller market power and can result in equally anticompetitive outcomes. When there is only one buyer of a good or service in a market, that buyer is often able to dictate the terms of the transaction that are more favorable to the buyer than would be expected under competitive conditions, and typically with a negative impact on ultimate consumers as well.

The type of buyer market power that I am most concerned about in the electric power industry is when a vertically integrated utility is able to foreclose competing generation from the wholesale market by simply refusing to purchase power from competing generators, even when power from competing generators is available at a lower cost. The incentives for a utility to engage in such foreclosure is typically not to drive down the price of purchased power below a competitive level (although that, too, may occur in certain instances), but rather in order to substitute its own higher cost generation for lower-cost competing alternatives. Since a regulated utility can maximize its profits by maximizing its rate base, it has an incentive to discriminate in favor of its own generation, even if that generation comes at a higher cost than competing alternatives, in order to ensure the continued inclusion of that generation in its rate base. Thus, in order for such buyer market power to be a significant concern with respect to competitive foreclosure, the utility typically must own a substantial amount of its own generation relative to its native load. Whether a utility is able

to foreclose competing generators through its monopoly position as the transmission owner, as has typically been the Commission's concern, or through its monopoly position with respect to native load, the impact on the wholesale market is the same, and fewer participating suppliers ultimately result in increased wholesale prices.

### **Affiliate abuse is not always easily separable from the other prongs of the Commission's market power analysis**

I have noticed that in these discussions, attempts are often made to draw sharp distinctions between "generation market power," "transmission market power," affiliate abuse, and barriers to entry, as if they refer to very different types of market power. In most cases, however, the central issue to be addressed with all four prongs is whether the applicant is able to increase prices or foreclose competition in wholesale generation. The Commission's four-prong test for market power provides an appropriate framework within which to review the structural conditions of a market, the applicant's position within that market, the potential impact of the applicant's continued control over transmission, the potential impact of the applicant's position as both a significant purchaser and a significant seller in the wholesale market, and the applicant's observed behavior, i.e., its demonstrated ability and willingness to use its dominant position in order to raise prices or foreclose competitors. In many instances, I do not consider these issues to be neatly separable; rather, they all simply reflect different aspects of an applicant's overall ability to exercise market power. Thus, while affiliate abuse as a conceptual matter deserves a full airing, it should not – and cannot – be considered in isolation from the other prongs of the Commission's market power analysis.

### **The Commission should apply a "rule of reason" rather than a bright line assessment of affiliate abuse**

Given the large number of applicants requesting market based rate authority, I realize that the Commission inherently faces a tradeoff between accuracy and expediency in establishing guidelines with which to identify the potential for affiliate abuse. Unfortunately, a "bright line" test for affiliate abuse that simply requires a code of conduct veers far too much towards expediency, with a very great risk – and in my mind, a near certainty – of authorizing market based rates for some participants with the clear potential to engage in affiliate abuse and thereby distort the functioning of competitive wholesale markets. For similar reasons, the Commission would also be ill-advised to wager on an OATT alone to ensure against transmission market power, or to wager on a limited check-list approach to identifying barriers to entry.

The Commission is not alone among various regulatory institutions in struggling with how to identify the elements of a "workably competitive" market and even what constitutes permissible market behavior in order to provide market participants with regulatory certainty while also fulfilling their legal mandate to protect competition and the public interest. I

would suggest that many of the issues raised in market based rate applications ultimately require a “rule of reason” type of approach, as is often used in antitrust analysis. The alternative, effectively forcing all concerns into a “per se” or bright-line test, is almost guaranteed to result in the exercise of market power – and worse, regulatory protection for the exercise of market power.

I do think that the Commission has embarked down the right road in its approach to analyzing generation market power by setting up indicative screens that are used to simply establish a “rebuttable presumption” of market power (or lack thereof), a procedural device that appropriately balances the competing demands for accuracy and expediency. I would suggest that the Commission follow a similar “rebuttable presumption” approach with respect to affiliate abuse, as well as with transmission market power and barriers to entry (which are simply subsets and supersets of affiliate abuse, respectively). For example, there should be a rebuttable presumption of affiliate abuse (or at the very least, the *potential* for affiliate abuse) and hence market power if:

- 1.) an applicant is a vertically integrated utility with continued ownership and control over transmission;
- 2.) there is no fully-functioning RTO in the market at issue;
- 3.) there is significant capacity from lower-cost competing generators located within the applicant’s control area;
- 4.) there is continued dispatch of the applicant’s higher-cost generation despite the availability of lower-cost competing generation; and
- 5.) there are complaints by intervenors that, if ultimately proven to be true, would constitute affiliate abuse.

If a rebuttable presumption of market power has been established, the ultimate determination by the Commission as to whether the applicant is able to exercise market power – including a determination of the appropriate mitigation – would ultimately then depend on a more detailed “rule of reason” analysis, based on weighing the substance and accuracy of the analyses presented by the applicant, intervenors, and/or Commission Staff, and obviously within the context of the Commission’s mandate to ensure just and reasonable, and not unduly discriminatory, rates.

Including the other prongs of the Commission’s market power analysis in such a “rebuttable presumption” approach is even more imperative, if in addition an applicant also fails the generation market power indicative screens, since it is necessary to consider the other three prongs in order to properly perform and evaluate a Delivered Price Test. The Delivered Price Test is a largely theoretical exercise that derives a market supply curve, based solely on the marginal costs for each generator, providing capacity-based market shares at various price levels. While such an exercise is useful, it is still incomplete until compared against

actual historical sales-based market share data. Such a comparison, in turn, can raise a number of important questions. How closely do the results of the Delivered Price Test compare to the applicants' actual market share? Is the divergence attributable to transmission constraints that effectively establish a barrier to entry to competing generators? Is the divergence attributable to affiliate abuse, e.g. preferential access to transmission service, the exercise of buyer market power, the imposition of additional costs on competing generators that are not borne by affiliates, or other means of impeding or foreclosing competing generators from participating in the wholesale market? The answers to these questions ultimately determine the conclusions one draws from such a generation market power analysis. Thus, an overall assessment of market power – and even generation market power alone – cannot be accomplished if each of these prongs is placed in a vacuum.

### **Independent competitive solicitations and auction markets prevent many forms of affiliate abuse**

Finally, as I indicated above, I do not consider codes of conduct or other behavioral forms of mitigation to be adequate in preventing affiliate abuse, even if such behavioral mitigation were fully specified. Ultimately, I believe that some form of structural mitigation is needed in order to prevent affiliate abuse, as well as in order to address transmission market power and barriers to entry. Obviously, a fully-functioning RTO – complete with wholesale auction markets – goes a long way towards mitigating affiliate abuse and preventing the foreclosure of competing suppliers. However, I also think the most important features of RTOs can be implemented without necessarily going all the way to an RTO, i.e. by establishing independent administration and oversight of the transmission network, along with well-functioning competitive solicitations or auction markets. In order for competitive solicitations and/or auction markets to be effective as a general means of preventing affiliate abuse, whether in the context of market based rate applications or requests for approval of a particular transaction, it is imperative that they be reasonably designed, independently administered, transparent to all participants, and free from a “commingling” of affiliates and employees on both sides of the transactions at issue. To the extent that the Commission increasingly looks to competitive solicitations or auction markets to protect against the exercise of market power, the Commission will go a long way towards advancing wholesale competition.